Shareholder Votes

A simple majority vote is required.

At some point, probably after AOL and Time Warner have received federal regulatory and legislative approval for their merger, the two companies will put the merger to a vote of their respective shareholders. Under the bylaws of each company, the merger will need to be affirmed by a simple majority of the shareholder votes outstanding with respect to the matter by each company's investor base.

Figure 29. Equity Ownership Table

	AOL	TWX	AOL TWX Combined
Executive Officers and Directors as a Group	1%	11%	5%
Institutional Investors	45%	72%	63%
Individual Investors	55%	17%	31%
Total Investors	**100%**	**100%**	**100%**

Source: Company documents, Spectrum Run dated December 31, 1999, America Online Proxy Statement dated September 22, 1999, and Time Warner Proxy Statement, dated March 30, 1999

We expect strong support from institutional investors and management.

In looking through the ownership of both AOL and Time Warner, it is relatively easy to see where many of the votes for the merger are likely to originate. At AOL, management and employees own 1% of the outstanding shares, and institutions hold another 45% or so of the equity. We would expect strong support for the merger from AOL's management shareholders as well as from most institutional investors. By deduction, perhaps 55% of AOL's shares are held by individual investors and we believe this constituency may be the swing vote in the process. Although AOL's share price has fallen 8% since the January 10 merger announcement, we believe most AOL investors, even price- and momentum-sensitive individual investors, see the strategic merit behind the combination. If we assume 75% of the institutional investors will vote in favor of the merger, AOL will probably need the support of less than one-sixth of its individual shareholder base in order to approve the merger. We believe that AOL's board of directors and management will likely stand behind the merger.

Figure 30. America Online Management and Director Ownership

	Shares Beneficially Owned[a]
Steve Case, Chairman and CEO	9,036,883
James L. Barkdale, Director	4,164,113
William N. Melton, Director	2,200,000
General Alexander M. Haig, Jr., Director	1,227,392
Francis J. Caufield, Director	1,067,586
Bob Pittman, President and COO	1,022,129
George Vrandenburg, III, Sr. VP Global and Strategic Policy	879,600
Michael J. Kelly, Sr. VP, CFO and Asst. Sec.	305,000
Kenneth Novack, Vice Chairman	199,259
Daniel F. Akerson, Director	144,000
General Colin L. Powell, Director	120,000
Franklin D. Raines, Director	108,000
Other	6,639,812
All Executive Officers and Directors as a Group (19 persons)	27,113,774

Notes: (a) Includes option shares.

Source: America Online Proxy Statement, dated September 22, 1999

On the Time Warner side, management owns 11% of the outstanding shares, while institutions own 72%, leaving individual investors with a 17% stake in the company. Within the Time Warner insider holdings, Vice Chairman Ted Turner has pledged to vote his 114 million shares (10% of the total) in favor of the transaction. On the institutional investor front, we believe that most of the investors who own Time Warner, or who will own it by the time of the shareholder vote, are likely to be in favor of the transaction. In the end, the shareholder vote process is a critical step in the process, but we believe AOL and Time Warner will easily garner the necessary votes.

Figure 31. Time Warner Management and Director Ownership

	Shares Beneficially Owned[a]
R.E. "Ted" Turner, Vice Chairman	114,210,853
Gerald M. Levin, Chairman and CEO	6,753,033
Peter R. Haje, Executive VP and General Counsel	1,450,004
Richard D. Parsons, President and Director	1,422,623
Merv Adelson, Director	1,405,376
Richard J. Bressler, Exec. VP TWI & Chair. and CEO TW Dig. Med.	670,156
Beverly Sills Greenough, Director	49,264
Francis T. Vincent, Jr., Director	42,564
Reuben Mark, Director	27,464
Michael A. Miles, Director	25,158
Gerald Greenwald, Director	19,890
Carla A. Hills, Director	12,664
J. Carter Bacot, Director	10,090
John C. Danforth, Director	7,010
Stephen F. Bollenbach, Director	3,090
Other	358,588
All Executive Officers and Directors as a Group (18 persons)	126,467,827

Notes: (a) Includes option shares.

Source: Time Warner Proxy Statement, dated March 30, 1999

Achievement of $1 Billion Synergy Target

A combined AOL Time Warner should easily meet its $1 billion EBITDA synergy target.

Beyond the closing of the merger, one of the litmus tests for the wisdom of the transaction will be AOL Time Warner's ability to achieve the $1 billion extra lift in first-year EBITDA that the companies have discussed. From our perspective, looking at a combined company with roughly $40 billion in revenue and $30 billion in cash operating costs, we do not believe $1 billion in incremental EBITDA should be overly daunting.

For instance, from a top-down perspective, if AOL Time Warner can cut 1%-2% out of the combined companies' cash operating costs in year one, the result would be $300-$600 million in additional EBITDA. Although the two companies do not have many direct overlaps, we believe these kinds of savings are achievable in the Web site development, marketing, back office, and network infrastructure areas alone. At the same time, if AOL Time Warner can produce 2.0%-3.0% more revenue growth in combination than they would individually, the result would be an additional $800-$1,200 million in revenue. If the combined companies were able to add that revenue at a reasonable marginal cost, perhaps 30%-40% of the newfound revenue, or $300-$500 million, could drop to the EBITDA line.

Elsewhere in this report, we have more specifically quantified the likely sources of cash flow uplift or synergy in the first year of combination, but our 2001 baseline calls for 60% of the uplift to come from cost savings and 40% from revenue gains. Looking further out, that mix ought to flip-flop toward one-third cost savings, two-thirds revenue gains. Likewise, in the near term, more of the EBITDA bump may come from Time Warner operations than from AOL operations, while accelerated Internet and interactive revenue becomes more important over time.

Federal Regulatory and Legislative Approval

We believe AOL and Time Warner will likely receive all necessary regulatory approvals.

The merger between AOL and Time Warner will be subject to the regular federal government approval processes: The FTC and the FCC, as well as approval from the European Commission and various Canadian governmental entities. Although AOL Time Warner will be the leading media company of the Internet age, and the combination will bring together assets and resources that can leverage off of each other in significant ways, we do not believe the AOL Time Warner merger should cross any free trade, antitrust, or regulatory lines. The combination brings together very few overlapping businesses and does not by itself lead to any excessive concentrations in any of the combined company's areas of operations.

Although AOL recently spoke before Congress, Congress has no formal role in the merger approval process. The FTC is the entity which is currently reviewing the proposed merger to ensure that it complies with federal antitrust laws. In fact, merger reviews performed by the FTC are supposed to be free from all political considerations. However, it is important to note that several House and Senate committees have broad legislative and oversight responsibilities for issues that affect the industry, such as privacy concerns and open access.

Local Approvals and Cable Franchise Transfers

Beyond the federal review process, AOL and Time Warner will also have to gain local approvals, particularly with respect to cable franchise transfers, in some areas. In the recent past, one sticky issue around cable transfers has been the Internet "open access" debate. In a few cities — notably Portland, San Francisco, and Los Angeles, among others — local or municipal governments have recently held up cable franchise transfers as they evaluated and deliberated over how Internet access would be offered over those cable systems. However, AOL and Time Warner recently signed a letter of understanding between the two companies that pledges them to "open access" on Time Warner's cable systems, putting the companies on the "right" side of the issue from the perspective of those cities and towns that have been holding up cable franchise transfers. In other words, AOL and Time Warner have already stated that they intend to allow other ISPs beyond AOL to serve their customers over the Time Warner cable infrastructure, and this is exactly what cities like Portland have recently been fighting for in the courts. We believe the cable franchise transfer process will likely be completed by the end of 2000.

Organizational and Management Decisions

At some point along the way to completing the merger, AOL and Time Warner will clarify and solidify the management and organizational structure of the combined company. However, both companies are comfortable leaving many of these decisions up in the air for the time being. The rationale for postponing the finalization of AOL Time Warner's organizational chart arises from senior management's desire to mix and intertwine the companies' people and operations as fully as possible before drawing up the new management model. We believe AOL Time Warner is aiming for a highly integrated corporate profile, one where warring fiefdoms and jealous divisional rivalries are uncommon, and where interaction, cooperation, and mutual reinforcement typify the way units work with each other.

By not yet setting a firm organizational structure — a single firm culture can more readily develop.

Obviously, AOL Time Warner takes on some degree of near-term risk by delaying these organizational decisions, as a sense of strategic direction and operational leadership could become lost or obscured. On the other hand, we believe that AOL and Time Warner are both currently enjoying a liberating period of heightened creativity and internal excitement, which is directly related to the fact that few rigid rules or segmentations have been imposed from the top down. Instead, people at Netscape are free to cross-pollinate with Time Warner, creating several "skinned" versions of the new Netscape browser; *Time*'s editors are free to put "AOL Keyword: TIME" on the cover of the magazine at their discretion; and AOL and Time Warner cable can sit on the same side of the table and knock out an open access agreement on the basis of the benefits to the merged company. As a result of delaying some of these organizational choices, an environment of integration and the culture of a single company may be better able to take hold.

In our conversations with Jerry Levin, he has suggested that it was possible, although highly improbable, that the new AOL Time Warner might be organized into a Content group, a Subscriptions group, and an Advertising/Direct Marketing group. While such a structure is unlikely, Mr. Levin's point is that the new company seeks to look at the possibilities ahead of it with as open a mind as possible. AOL Time Warner is focused on finding new business opportunities and inventing new markets; protecting existing kingdoms and bowing to existing corporate customs is not part of the plan. Among other ideas, we could envision AOL Time Warner organizing the online service and the cable systems as parallel business platforms, into which each of the other divisions would be plugged. In the end, though, a new organizational framework should gradually start to emerge, and investors should keep an eye out for how management authority and responsibility will be divided up within the new company. In the process, some executive departures may be inevitable, but as long as Levin, Case, Pittman, and Kelly remain on board, as well as Parsons and Bressler, we believe that the business will remain in the hands of one of the best-equipped teams in the rapidly changing world of the media industry.

Further Commercial Agreements

At the time the merger was announced, AOL and Time Warner simultaneously announced a series of commercial agreements between the two companies. Since January, the two companies have followed up with additional commercial agreements as well as some more strategic moves, including Time Warner's EMI acquisition and the letter of understanding regarding cable broadband "open access." In many ways, AOL and Time Warner are already operating as one "virtual company," and we anticipate a continued stream of commercial agreements and strategic interoperation between the two companies. Although a company with $40 billion in merged revenue is unlikely to get much near-term financial bang out of one or two (or ten) of the kind of deals that AOL and Time Warner have recently been launching, we believe the momentum established by these pre-merger alliances will carry over into the early days of the new company.

Appendix

New media boost technology industries and new technology boosts media industries.

In the Appendix, we review the industry wide financial impact of the convergence of Media with Technology and Content with Distribution. History shows us that in each of these examples—PC, Music, and more specifically, the combination of the Turner and Time Warner television businesses—a value generation occurred that was significantly greater than the sum of the parts. Accordingly, we argue that the combination of AOL and Time Warner is the classic combination of technology and media that creates incremental growth on both sides. Generally, the synergistic power between media and technology works in two directions. Historically, we have seen the application of new content boost technology businesses and we have also seen the creation of new technology advance media businesses. Similarly, we posit that the application of Time Warner's superior content to AOL's technology business will accelerate AOL's growth, and at the same time the infusion of AOL's cutting-edge technology will spur growth of Time Warner's media business.

The Day the Music Came Back with a Vengeance

Introduction of the CD technology gives a lift to the music industry.

Compact disc technology was not utilized by the music industry until 1983 and CDs were not widely available until 1984. Between 1980–83, prior to the mass distribution of music CDs, overall recorded music industry expenditures actually declined, resulting in a negative compound growth rate. However, commensurate with the early adoption of CDs, we see a growth spurt in recorded music sales of 15% between 1983–84. Further, if we look at the period prior to widespread CD distribution (between 1980–84), we calculate a compound annual growth rate of only 3%, compared with the healthy 11% compound growth rate for the following decade (1985–1994) where the music CD became the standard form of distribution for recorded music. It is clear from these numbers that the introduction of CD technology was the primary growth catalyst for recorded music sales. Further, we see that as the CD gained market share, it also spurred overall music sales growth. In 1984, CD sales represented only 2% of the total music industry revenue; however, between 1984 and 1994, the market share of CDs of total music sales rose from 2% to 70%, and the annual growth rate also grew, reaching 20% in 1994. To arrive at the growth rate of the music industry without the effect of CDs, we can compare total non-CD music sales in 1984 of $4.3 million to total non-CD music sales in 1994 of $3.5 million (equal to the difference between 1994 total music sales of $12.1 million and 1994 CD sales of $8.5 million), and we can clearly see that music sales outside of CDs actually declined over the period. We have here a clear case study of a significant $14 billion media-based industry that tripled its growth rate through the advent of a new technology, the CD. This illustration proves the point that media businesses can clearly be transformed into a growth cycle through the introduction of new technologies.

With the introduction of Compact Disc technology, music companies were able to offer a superior product which had increased durability, noticeably better sound quality, easier track switching capabilities, and smaller size for ease of storage and portability. The availability of a superior product caused most purchasers of recorded music not only to purchase new artists on CDs, but also to actually go out and replenish their current collections with the same albums that they currently owned. Thus, this new technology not only stole market share, but also worked to increase the whole pie, making it more appealing for people to become consumers of music.

Digital Music

Digital download technology will once again transform the music industry.

While many of us have personally seen the CD transform the music business, we are likely to experience another technology-driven period of change. We believe that the development of digital downloading will once again transform the music business. Not only will digital downloading garner market share away from what are now considered traditional forms of distribution, such as CDs, it will once again increase the total pie, making it even more desirable for consumers to purchase recorded music. The digitization of music will allow consumers to more conveniently and quickly purchase recorded music, have access to a wider variety of lesser-known artists, and personalize their purchases of music by not limiting purchases to popular singles or whole albums, but instead allowing the purchase of small quantities of less popular songs from multiple artists.

Upon the consummation of the merger, Time Warner (together with the EMI Group), the second-largest music company in the world, will be combining its huge vault of record labels with AOL's leading distribution capabilities through Spinner.com and Winamp. Together, Time Warner and EMI represent 2,500 musicians. EMI operates under the Virgin, Priority, and Capitol record labels, including names like the Rolling Stones, the Spice Girls, Van Morrison, and Frank Sinatra. Time Warner operates the Atlantic, Elektra, and Warner Brothers record labels, which include Cher, Jewel, Natalie Merchant, Eric Clapton, Phil Collins, Madonna, Metallica, and REM. AOL, on the other hand, is the No. 1 Internet online service with the most powerful collection of interactive brands. AOL has the strongest distribution potential of any Internet company, given that it has the largest base of paying Internet subscribers in the world and the furthest reach of any online company (reaching 66% of the total online population in December 1999). Combining this user base and reach with AOL's Spinner.com, the first and largest Internet music service (with over 175,000 digitized songs delivered on over 125 specialized music channels), and AOL's Winamp, the world's leading high-fidelity audio player (leading the industry in number of digital downloads), you have an unparalleled distribution platform in which to deliver Time Warner's massive library of music. Together, AOL Time Warner will once again transform the music business by using its leading digital music technology to transform the music media industry.

Personal Computers

The multimedia CD revitalizes the PC industry.

While CD technology and the music business is a great example of how technology transformed a media business, the introduction of the multimedia CD-ROM for personal computers is a great example of how media transformed a technology business. Prior to the advent of multimedia capabilities, the PC was not a consumer-friendly tool. However, following the widespread offering of expansive media content on the PC through the use of multimedia CD-ROMs, we saw a surging increase in consumer demand for PCs.

By examining worldwide PC shipments in the late 1980s and 1990s, we can see a quantitative example of how the introduction of media transformed the PC industry. From 1988–1991, we saw a steady growth in PC shipments, with the growth rate starting to decline around 1991. Then in 1992, we see the introduction of the multimedia CD-ROM. Throughout the 1992–95 period, the variety in CD-ROM titles rapidly rose and more engaging CD-ROMs emerged. Correspondingly, in the pre-multimedia years, from 1988–1991, total PC shipments averaged 22.5 million per year. Following the introduction of the CD-ROM, from 1992–95, we saw total PC shipments per year almost double to an average of 44.0 million per year. Essentially, the ability to utilize media through the PC increased the growth rate for the PC industry. The compound annual growth rate between 1992–95 more than doubled, to 18%, from the compound annual growth rate of 7% for the earlier period from 1988–1991. Further, we see a peak in the growth in PC shipment in 1995, with an increase of 26% from 1994, which is commensurate with the time that a large variety of different types of media CDs became widely accessible and the same time that Windows 95, an operating system that could easily handle multimedia CD usage, was made available to the public. We see similar confirming evidence when we look at PC household penetration. During the five-year period between 1987–1991, we see the household PC penetration growth rate increasing at an average rate of 2% per year. However, during the following five-year period, we see the PC household penetration growth rate increasing at an average rate of 3% per year. From these examples, we see how the introduction of media (through multimedia CD-ROMs) drove an increase in demand for the technology-based PC business.

The Internet is once again reshaping the PC industry.

With the Internet, we are currently in the midst of the next transformative media wave. The Internet offers the user the capability of receiving real-time, interactive media content on demand. The desire to get on the Internet to gain access to this new form of media content has fueled increased demand for PCs. Further, as the quality and diversification of media content available on the Internet continues to increase, so does the demand for PCs. After the initial impact period of the multimedia CD, we saw PC shipment growth rates begin to decline in 1997 and the beginning of 1998; however, by 1999 we saw demand soar again, with growth rates for PC shipments rising to 25%. In 1999, we saw PC shipments rise to over 112 million PCs, 22 million more shipments than in the previous year. This incremental growth of 22 million PCs is more than twice the incremental growth for both 1998 and 1997. While the Internet has been in existence for a long while, only recently have we experienced the widespread availability of quality media content on the Internet. It is no coincidence that the emergence of diverse quality media content through the Internet is concurrent with a new surge in consumer PC demand.

Broadband will spur the next era of transformation.

The next likely example we will encounter of media transforming a technology-related business will be broadband media driving increased Internet usage (and subsequently increased demand for PCs). Although similar to the case of the multimedia CD-ROM and narrowband Internet media content, we expect that the greatest growth in Internet usage will arise once broadband content increases in variety, improves in quality, and becomes more engaging to the consumer, which still lies off in the future. However, we believe that AOL Time Warner will be the best-suited company to take advantage of the inevitable boost to Internet usage provided by the widespread availability of interesting broadband content. As the No. 1 provider of Internet services, AOL will likely gain more than its fair share of future first-time Internet users moving onto the Internet for a glimpse of this new form of content. Additionally, armed with Time Warner's unbeatable film, TV, and music library, as well as its magazine and book content, AOL will be well-positioned to offer the largest variety and most appealing broadband content to its users. Additionally, it is likely that consumers will be willing to pay premium prices to have access to top-quality broadband content.

Turner Broadcasting

The Turner acquisition is a prime example of the power of combining content with distribution.

In our opinion, Time Warner's 1996 acquisition of Turner Broadcasting for approximately $7.5 billion underscores not only Time Warner's ability to integrate acquisitions, but also the strategic and financial merits of groundbreaking mergers. The basic tenets behind Time Warner's merger with Turner Broadcasting include providing the Turner cable networks with leading Warner Bros. filmed entertainment product to drive ratings and to strengthen Turner's advertising revenues by leveraging Time Warner's existing relationships with advertisers.

By all measures, the Turner acquisition has been a home run for Time Warner. Although disparate accounting policies (particularly in film accounting methods) and purchase price adjustments limit the comparability of Turner Broadcasting's performance prior to and post the Time Warner merger, it is clear that EBITDA growth for Turner Broadcasting has accelerated since being folded into Time Warner. In the five years before the merger with Time Warner (1991–95), Turner Broadcasting EBITDA grew at a compound annual growth rate of about 9%-10%. Since the deal was closed in 1996, Turner EBITDA under the guidance of Time Warner has grown at a 39% compound annual clip. However, recognizing that 1996's base level of EBITDA was artificially depressed by purchase adjustments, we have also examined Turner's performance over the period from 1997–99. Over this time frame, EBITDA has grown at a 17% compound annual rate (21% growth for Turner Networks and 2% for TBS Film), still a marked acceleration in cash flow growth.

The Turner acquisition similarly galvanized the stock performance of Time Warner. Through the first half of the 1990s, Time Warner's shares essentially traded sideways as difficulties from the original Time, Inc. and Warner Communications merger took hold. From 1990–95, Time Warner's stock rose an unimpressive 22.1% (or an average annual return of 4.4%), under performing the S&P 500 by 52.1%. However, with the financial success of the Turner merger, Time Warner's stock surged 279.3% from 1996-99 (a 93.1% average annual return), outperforming the broader market by 142.6%.

Notes

Notes

Companies mentioned in this report:

Cisco Systems Inc (CSCO-$140.86; 1M)
Exxon Mobil Corp. (XOM-$77.00; 1L)
General Electric (GE-$150.00; 1L)
Int'l Business Machines Corp.# (IBM-$113.50; 1M)
Intel Corporation (INTC-$138.44; 1M)
Lucent Technologies, Inc.# (LU-$67.00; 3M)
Microsoft Corporation (MSFT-$102.75; 1M)
Oracle Corporation (ORCL-$80.69; 1H)
Wal-Mart Stores# (WMT-$56.63; 1L)

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST US03H196

Guide to investment ratings: *RANK* is a guide to the expected total return over the next 12-18 months. The total return required for a given rank depends on the degree of risk (see below) in a stock. The higher the risk, the higher the required return. For example, a 1 (Buy) rating indicates a total return ranging from 15% or greater for a low-risk stock to 30% or greater for speculative stocks. Estimated returns for other risk categories are scaled accordingly. *RISK* takes into account predictability of earnings and dividends, financial leverage, and stock price volatility. *L (Low Risk):* predictable earnings and dividends, suitable for conservative investors. *M (Medium Risk):* moderately predictable earnings and dividends, suitable for average equity investors. *H (High Risk):* earnings and dividends are less predictable, suitable for aggressive investors. *S (Speculative):* very low predictability of fundamentals and a high degree of volatility, suitable only for investors/traders with diversified portfolios that can withstand material losses. *V (Venture):* indicates a stock with venture capital characteristics that is suitable for sophisticated investors with a high tolerance for risk and broadly diversified investment portfolios. A thorough explanation of the ratings system is available upon request.

FIRST UNION Securities

EQUITY RESEARCH

AOL TIME WARNER (AOL–NYSE)

Rating: 1

June 20, 2000
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REPORT OBJECTIVE: Initiation Of Coverage
INVESTMENT OBJECTIVE: Growth And Value
INDUSTRY GROUP: Media & Entertainment
HEADQUARTERS: New York, New York

Price (6/19/00)	**$54 1/2**
52-Wk Range	$96–$37
Dividend	none
Yield	nil
Book Value	$31
Quality Rating	3
Trading Data	
PF Shares Outs (MM)	4,777
PF Est. Float (B)	3.4
Avg. Daily Vol. (MM)	AOL–15.65
	TWX–4.078
PF Market Value (B)	$260.4
PF Inst. Holdings	47%
PF Insider Holdings	5%
3 Year EBITDA Growth Rate	**24%**
3 Year Cash Earnings Growth Rate	**40%**

		Pro Forma*		
Estimates (FY 12/31):	**1999A**	**2000E**	**2001E**	**2002E**
Q1-March	($0.26)	($0.22)A	NE	NE
Q2-June	(0.23)	(0.21)	NE	NE
Q3-September	(0.23)	(0.20)	NE	NE
Q4-December	(0.19)	(0.16)	NE	NE
Full-Year EPS	**($0.90)**	**($0.79)**	**($0.47)**	**($0.15)**
EBITDA (a)	**$7,472**	**$8,914**	**$11,592**	**$14,285**
EV/EBITDA Multiple		**30.6X**	**23.6X**	**19.1X**
Cash Earnings (b)	**$0.50**	**$0.65**	**$0.93**	**$1.37**
Cash Earnings Multiple		**83.8X**	**58.6X**	**39.8X**
Revenue (MM)	$33,050	$37,413	$43,691	$50,393
Return on Equity	NM	NM	NM	NM

Capitalization (3/31/00)	**$MM**	**%**
Net Debt	17,101	10%
Shareholders' Equity	153,069	90%

** All estimates are pro forma for AOL/TWX merger.*
Note: AOL has a June fiscal year end. However, to ease comparability, earnings are presented on a calendar year end basis. This is consistent with the merged company's planned fiscal year.
(a) Earnings and EBITDA are adjusted for non-recurring items.
(b) Cash earnings includes earnings plus goodwill amortization, adjusted for non-cash taxes due to company's NOLs.

Key Points

- *The merger provides AOL with content, cable access, and a powerful media platform, while Time Warner can leverage its brands over the Internet in a way that was simply not possible before; we view this as a powerful combination*
- *The bottom line is that this is a strong growth story trading at a price that even value-oriented investors should find compelling given its strong economics*
- *We look for 47% upside to our target price of $80*

AOL Time Warner will be a leading diversified media, entertainment, and communications company. Its primary assets will include the premier Internet service, cable systems, branded cable networks, and leading operations in publishing, music, and film/television production.

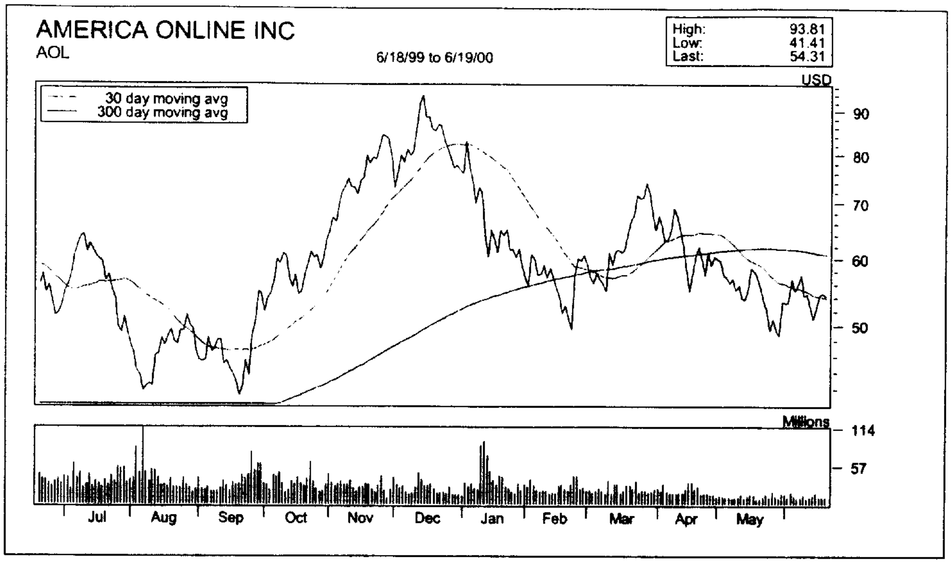
INVESTMENT SUMMARY: STRONG BUY

While many in the investment community are debating short-term-oriented questions (i.e., who bought who?, how do you value a blended Internet and media company?, etc.), a window of opportunity has been created to buy a uniquely positioned growth company with premier content, distribution, and Internet assets. The proposed merger between America Online and Time Warner creates a company that is No. 1 or No. 2 in virtually every business where it competes. With 23–25% long-term EBITDA growth and powerful free cash flow generation, the valuation is compelling using traditional media metrics. In other words, there is no need to rely on historical Internet valuations to justify significant upside from current levels. Our 12-month target price is $80 per share for AOL, equivalent to $120 per share for Time Warner based on the 1.5 merger exchange ratio – almost 50% expected appreciation. We recommend aggressive purchases and are initiating coverage of AOL and Time Warner with a Strong Buy (1) rating.

Rating Legend
1 – Strong Buy
2 – Buy
3 – Hold
4 – Underperform
5 – Sell

TABLE OF CONTENTS

Note: This company report is an excerpt from our initiation report dated June 20, 2000. Periodically, references are made to detailed discussions included within that publication. Copies of our initiation report are available upon request.



Source: FactSet

KEY POINTS

- AOL Time Warner will be a leading diversified media, entertainment, and communications company. Its primary assets will include the premier Internet service, cable systems, branded cable networks, and leading operations in publishing, music, and film/television production.
- The merger provides AOL with content, cable access, and a powerful media platform, while Time Warner can leverage its brands over the Internet in a way that was simply not possible before. We view this as a powerful combination.
- The company derives 70% of its total EBITDA from Time Warner and 30% from AOL. With Time Warner's properties growing EBITDA in the long term at 11%-13%, and AOL growing EBITDA at 40-45%, the combined company should show impressive long-term growth around 20% before synergies.
- Estimated synergies of $1 billion in the first year should accelerate EBITDA growth to about 30% in 2001 and bring EBITDA growth closer to 23-25% in the long term. Cash earnings should compound near 45-50% for the foreseeable future.
- The ability to generate free cash flow will be impressive. We estimate more than $5.5 billion in free cash flow in 2001, growing 50%. The company has the enviable challenge of figuring out what to do with all that cash; aggressive stock repurchase is one obvious choice.
- Our 12-month price target for the combined company is $80 per share, based on a 27x multiple of 2002 estimated EBITDA. This is equivalent to a 58x multiple of 2002 estimated cash earnings and is consistent with our private-market-value analysis.
- The bottom line is that this is a powerful growth story trading at a price that even value-oriented investors should find compelling given its strong economics.
- In addition, there are several catalysts on the horizon that could narrow the disconnect between the stock price and the underlying value. These include closing of the merger (in the fall); an open access agreement between AOL and Time Warner (imminent); and an agreement with AT&T regarding cable telephony, open access, restructuring TWE, and a host of other topics (sometime after the merger).

VISIONARY MERGER BREEDS CONFUSION—GREAT INVESTMENT OPPORTUNITY

As The World Comes To Terms With A True Mega-Merger, The Stock Price Slides

The focus has been on short-term questions—it's time to move forward

When a merger like AOL and Time Warner occurs (not that one ever has before), there is naturally a period during which everyone (i.e., the Street, investors, competitors, the press, etc.) struggles to think about the new giant on the block in understandable terms. To put the new company in the proper context, we sense that, to date, the preoccupation has been on fairly short-term-oriented questions and concerns. In turn, the focus has been somewhat misdirected from what really matters. For example, we most often find discussions revolving around the following types of issues.

- **Question:** Who bought who?

  Answer: Who cares. Of course, AOL is the surviving stock, but this is a merger in which both parties are partnering to create a company that is stronger than either of the individual pieces.

- **Question:** Is it an Internet company with media assets, or a media company with an Internet brand and service?

  Answer: It is neither of the above and both of the above at the same time. The combined entity is a leading media, entertainment, and communications company—which piece of the company is more dominant is largely irrelevant, and the answer is highly dependent on who's answering the question.

- **Question:** How do you value it?

  Answer: To be sure, there was a fair amount of confusion when the deal was first announced. This was the first instance in which the world of Internet valuations combined with more traditional media valuation metrics. As a result, there was a natural period in which the shareholder base rotated—some AOL investors balked at lower near-term growth, while some Time Warner shareholders felt uncomfortable with such a large exposure to the Internet. Consequently, it was a reasonable "trade" to expect the stock price to decline shortly following the announcement of the merger. At this point, however, we believe the shareholder base has settled, and the answer regarding valuation is as it has always been—look at the growth, risk, and return characteristics. They are impressive in this case.

Opportunity To Buy A Uniquely Positioned Growth Company At A Compelling Valuation

A window of opportunity exists to make aggressive purchases

While the prevailing focus continues to be somewhat short-sighted during this initial adjustment period, an opportunity has been created to buy a company that is uniquely positioned from a strategic standpoint with premier content and distribution assets, and that is one of the dominant brands in the Internet industry. AOL Time Warner is No. 1 or No. 2 in virtually every business where it competes. Moreover, the combined company has the scale to launch new products and services easier, cheaper, and with less risk than anyone else given their established infrastructure and consumer reach; the company deals with more than 2 billion people every month around the world.

As discussed in the coming sections of this report, with 23–25% long-term EBITDA growth and more than $5.5 billion in estimated free cash flow in 2001 (growing about 50%), AOL Time Warner offers powerful growth at a price that even value-biased investors should find compelling. There is no need to rely on historical Internet valuations here—we recommend aggressive purchases at current levels.

WHY THE MERGER MAKES SO MUCH SENSE...

Mr. Case, Mr. Levin...You've Got Your Wish List

We are convinced that Mr. Case and Mr. Levin are true visionaries, thinking not only about how to enhance existing revenue streams, but also about how to be at the forefront of new business models. With this in mind, we suspect that AOL's ideal "wish list" would be to have a partner possessing three things: strong content, cable distribution, and a massive media platform. Time Warner is the only company that could have provided all three. Our reasons for believing this are as follows:

- **Offensive Use Of Content**. The company has made it very clear that Time Warner's content will not be available exclusively on AOL's service. To do so would harm the content, which needs to be available through as many distribution channels as possible. As a result, this is not really about using the content in a defensive way (i.e., don't quit AOL or you won't get the Superman short film). Rather, owning the content allows AOL to offensively control the means of production. For example, AOL TV needs interactive programming, which otherwise would likely be much slower in coming if AOL had to rely on third-party suppliers. In addition, the content can also be used offensively to increase the number of subscribers by packaging products and services (i.e., buy AOL and a *People* magazine subscription for one low price). The opportunities here are numerous.
- **Defensive Use Of Cable**. As discussed in the cable industry section of this report, commercially negotiated "open access" of ISPs on cable broadband would have come eventually, but with the pre-existing adversarial relationship, eventually may have taken far too long for AOL. AOL's strategy is to have its service available to consumers across a broad array of distribution platforms—via narrowband over telephone lines, cable, DSL, portable devices, etc. Of the $22 per month that AOL charges for its branded service, about $12 goes towards paying for access and billing, and $10 is left over as compensation for the content and community that AOL provides subscribers. This is a good business for AOL, with nearly 50% margins. Therefore, to lose that $10 per month in gross profits as consumers upgrade to broadband over cable would have been difficult for AOL. In contrast, by owning cable, AOL is now ensured of access to Time Warner's cable subscribers. But, more importantly, this is only the first step in achieving open access throughout the cable industry. We expect agreements with other cable operators to follow the lead of AOL and Time Warner. With AOL no longer a nemesis of cable (looking for regulated open access), it is a win-win situation for both the cable industry (higher penetration) and AOL (more cable modem customers).
- **Media Platform**. Owning a vast media platform has obvious advantages in terms of cross-selling advertising and cross-promotion of products and services.

From Time Warner's perspective, the goal is fairly straightforward: leverage its branded content over the Internet. The company has always been a strong supporter of new technologies and interactive services, although the results have historically been disappointing (Pathfinder and the Full Service Network are two examples). Therefore, the merger allows the company to obtain the Internet presence that it has historically been unable to build for itself. There is no better partner than AOL given its dominant brand, strong and growing base of 23 million subscribers, and technological expertise.

Synergies—Operating, Strategic, And Transforming—$1 Billion In 2001 And Growing Fast

Synergies of the merger are one of the key drivers of the story here. Some of the synergies are low hanging fruit that should be easy to achieve. Other benefits will come over time and are less easily quantifiable as the converging media landscape takes shape with AOL Time Warner firmly positioned as one of the leaders. As a result, we expect the $1 billion in estimated synergies in the first year to grow over time (30-40%) as the companies move beyond simple operating efficiencies to strategic areas for enhancing the revenue of existing businesses and even pioneering whole new business models.

Management describes the synergies as falling into three categories: operating, strategic, and transforming. We find this to be a useful way of thinking about the multitude of benefits to be achieved in the merger. Here's our attempt to classify the synergies:

Operational synergies should be the bulk of the savings in the near term

Operational Synergies: tactically enhancing existing revenue streams and cutting costs.

- **Cross-Selling Advertising.** Time Warner should be able to dramatically increase its level of Internet advertising sales on its websites by leveraging AOL's depth of relationships. In turn, AOL will benefit from Time Warner's scope of relationships, thereby allowing it to expand its list of buyers. We estimate that the advertising upside alone could total $300-$400 million in revenue in the first year.
- **Cross-Promotional And Packaging Products And Services.** AOL Time Warner should be able to sell more products and subscriptions, as well as attract more eyeballs, through cross-promotion and joint packaging. For example, cross-promotional opportunities include putting AOL keywords on magazines, or Warner music artists of the week on AOL. Packaging products and services should also prove incremental, such as joint-selling cable services with AOL, or how about three free months of a magazine subscription for AOL subscribers. At the end of the day, we would expect higher revenue from magazines, cable, HBO, AOL, movies, television shows, music, and websites (increased traffic).
- Magazines should also benefit from better economics on new magazine launches, and the gradual shift in the renewal process for subscriptions. By marketing new magazines and renewing subscriptions online (automatically with a credit card on file), the economics of the magazine business will improve over time with higher renewal rates, lower subscriber acquisition and mailing costs, and reduced risk.
- Cost savings on the distribution of AOL disks will be an immediate impact. AOL spends about $1 billion a year on promotion, about half of which is from the distribution of disks. By shrink wrapping the disks with magazines, burning the software onto music CDs, and having them available in Warner Bros. Stores, we expect this cost to come down by $150–200 million per year.
- Cost savings will also be material by eliminating much of the start-up costs for Time Warner's new digital media initiatives, such as Entertaindom. By leveraging AOL's existing infrastructure, the estimated start-up losses of about $225 million in 2001 should be reduced by $100–150 million.
- It is also reasonable to assume some cost savings in corporate overhead due to the elimination of various duplicate back-office operations.

Strategic synergies will really take hold in a few years

Strategic synergies: facilitating new revenue sources from existing businesses.

- Being able to gain access to cable broadband was a critical missing piece for AOL in its AOL Anywhere strategy. As mentioned above, the merger opened the door not only for access to Time Warner's cable systems, but it also serves as a catalyst for open access throughout the industry. Eliminating the risk of erosion in AOL's subscriber base as some customers choose to switch to cable modems is a major strategic synergy of the merger.
- On the other hand, having AOL as a partner in the promotion of cable modems is also a significant benefit for Time Warner and the entire cable industry. No longer the nemesis fighting for regulated open access, AOL should help spur demand for cable modems. We believe that this is likely to be more relevant in the long run; the near-term bottleneck is not demand, but installation speed.
- In addition to cross-promotional opportunities for the traditional sale of music, partnering with AOL should also help to accelerate the speed of consumer acceptance of digital downloading. More importantly, however, we believe that the bigger synergy for music (including the industry as a whole) comes from eliminating a potential threat. AOL was in the position of pushing whichever digital format of music was best for the consumer. Now, with ownership of one of the largest music companies in the world, we suspect greater diligence will be made to push consumers to use a format that is more protective of copyrights. Gnutella (a service similar to Napster for sharing music) was quickly pulled by AOL after its launch; we wonder if that would have happened in the absence of the merger.
- AOL will now have the ability to accelerate the creation of interactive programming to improve the quality of AOL TV. The content would have followed eventually (assuming it is successful), but AOL TV will have the right kind of programming to help fuel demand.

Transforming synergies... things we can't see yet

Transforming synergies: developing new business models and transforming industries. By definition, these synergies are not yet identifiable. Nevertheless, AOL Time Warner is well positioned to take a leadership role and be an agent for change. Remember that given the company's infrastructure scale and consumer reach, it is easier, cheaper, and less risky to launch/incubate new products and services. We will have to wait and see exactly how that develops.

Estimated Synergy Breakdown By Line Of Business

It is extremely difficult to predict with accuracy how the synergies will break down amongst the various business categories. Nevertheless, it is a useful exercise to attempt to quantify the various dynamics discussed above. The following table illustrates our attempt to categorize the $1 billion in EBITDA synergies in 2001, which we estimate should grow by about 40% in the following year. Please note that we use this estimated breakdown in our projection model, which is discussed in the following section.

Estimated synergy breakdown used in our projections

Table 1: Projected Synergy Breakdown—PF2001E & PF2002E ($ In Millions)

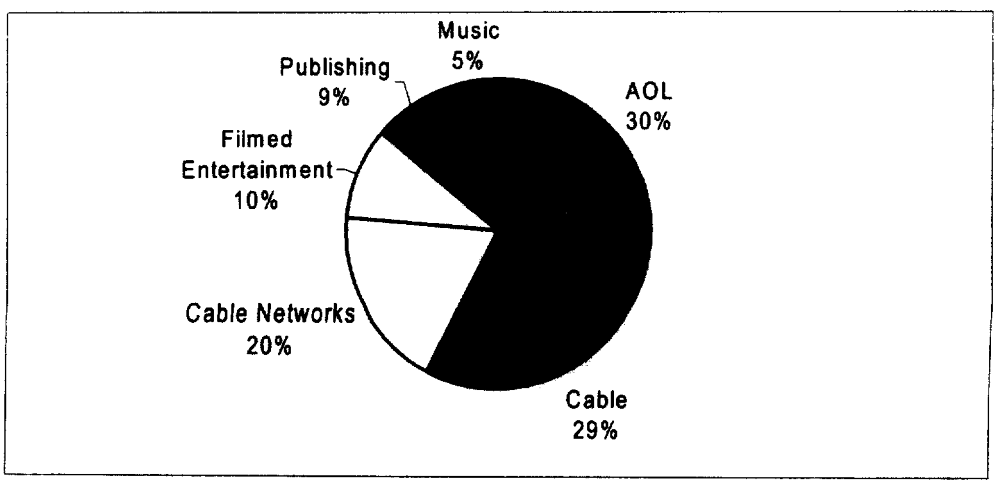
			% Change
Revenue Synergies:	PF2001E	PF2002E	'01/'02
Cable Networks	$110	$155	41%
Publishing	170	221	30%
Music	75	98	30%
Filmed Entertainment	50	70	40%
WB Network	10	30	200%
Cable	100	150	50%
AOL	300	420	40%
Time Warner Digital Media	25	75	200%
Total Revenue Synergies	**$840**	**$1,219**	**45%**
EBITDA Synergies:			
Cable Networks	$83	$116	40%
Publishing	85	111	30%
Music	20	30	48%
Filmed Entertainment	60	81	35%
WB Network	8	24	200%
Cable	75	113	50%
AOL	480	672	40%
Time Warner Digital Media	125	175	40%
Total EBITDA Synergies	**$936**	**$1,320**	**41%**
Corporate Overhead Synergies	60	75	25%
Total Operating Income Synergies	**$996**	**$1,395**	**40%**

Source: First Union Securities, Inc., estimates.

WE PROJECT 23–25% LONG-TERM EBITDA GROWTH, 30% IN PF2001

Business Mix—70% Of EBITDA From Time Warner Assets, 30% From AOL, Before Synergies

Chart 1: Projected Breakdown Of EBITDA—2001



Source: First Union Securities, Inc., estimates

Let's do some simple arithmetic before making any assumptions regarding synergies from the merger. Total EBITDA in 2001 is estimated at $10.7 billion. As shown in Chart 1, about 70% of that EBITDA comes from Time Warner, which consistently grows by 11-13% (as it has for years). The primary drivers for Time Warner's growth are its powerful cable networks (18-20% growth), HBO (15% growth), and cable systems (12-14% growth). The other 30% of total EBITDA comes from AOL. Growth at AOL is driven by the company's dominant market share of the fast-growing online universe. In turn, subscription service revenue is expected to grow in excess of 20% through 2002. In addition, as the No. 1 brand on the Internet, with 26 million total subscribers, advertising revenue is growing at an astounding rate. AOL is as close as one can get to being a must-buy for advertisers in the Internet space. As a result, with approximately 30% total revenue growth and declining telecommunication charges (which are almost one-third of total revenue), we look for EBITDA at AOL to grow by about 40%-45% in 2001 and 2002. Just simply adding the two companies together leads to EBITDA growth in the low-20s% range (before synergies).

Synergies Should Significantly Accelerate Growth

We estimate that with the onset of the $1 billion in synergies in the first year, 20% EBITDA growth will accelerate to about 30% in 2001. Moreover, as the company moves beyond simple operating efficiencies and onto strategic benefits of the merger, the long-term growth should also be higher than it otherwise would be. We look for 23 -25% long-term EBITDA growth, versus only 20-21% pre-synergies. Cash earnings, which we use for valuation purposes as explained in the next section, should grow closer to 45%-50% for the foreseeable future. The bottom line is that AOL Time Warner is truly an engine of growth.

What our projections are assuming

It is worthwhile to offer a few comments on our projections, which are shown in Table 2. First, they are obviously on a pro forma basis for the merger. We have restated numbers going back to 1998. However, they are not pro forma for the proposed joint venture between Warner Music and EMI—one merger at a time, please. Additionally, the information is not readily available to do a complete set of pro forma numbers (given different fiscal years). The joint venture is not expected to close until after the AOL Time Warner merger. Once completed, the joint venture will be consolidated on AOL Time Warner's books; then, 50% of the EBITDA will need to be backed out for valuation purposes. However, since Warner Music and EMI are roughly the same size, the valuation is not materially distorted by ignoring the joint venture altogether. There is one exception to this—cost savings from the joint venture are expected to be significant (at least $400 million over a few years). As a result, it is reasonable to view our projections as conservative since we are not including AOL Time Warner's half of the cost savings. On a separate note, we also wish to point out that with material non-recurring gains in EBITDA, primarily in cable and Warner Bros., investors should focus on the adjusted EBITDA figures at the bottom of the projections. Cash earnings also adjust for non-recurring items.

Table 2: Pro Forma Earnings Projections—1998–2002E ($ In Millions)

	PF1998	PF1999	PF2000E	PF2001E	PF2002E	% Change PF1999	% Change PF2000E	% Change PF2001E	% Change PF2002E
Revenues:									
Cable Networks	$5,377	$6,111	$7,040	$8,206	$9,478	13.7%	15.2%	16.6%	15.5%
Publishing	4,496	4,663	4,608	5,054	5,398	3.7%	-1.2%	9.7%	6.8%
Music	4,025	3,834	3,886	4,155	4,422	-4.7%	1.4%	6.9%	6.4%
Filmed Entertainment	7,978	8,075	8,682	9,324	9,978	1.2%	7.5%	7.4%	7.0%
WB Network	260	384	453	495	588	47.7%	18.1%	9.2%	18.7%
Cable	5,342	5,374	6,045	6,953	7,918	0.6%	12.5%	15.0%	13.9%
AOL	3,847	5,718	8,029	10,934	14,106	48.6%	40.4%	36.2%	29.0%
Time Warner Digital Media	-	-	-	25	100				
Intersegment Elimination	(1,234)	(1,109)	(1,329)	(1,456)	(1,596)	-10.1%	19.9%	9.6%	9.6%
Total Revenues	**30,091**	**33,050**	**37,413**	**43,691**	**50,393**	**9.8%**	**13.2%**	**16.8%**	**15.3%**
Total Revenues (Without Synergies)	**30,091**	**33,050**	**37,413**	**42,851**	**49,174**	**9.8%**	**13.2%**	**14.5%**	**14.8%**
EBITDA:									
Cable Networks	1,276	1,529	1,780	2,171	2,568	19.8%	16.4%	21.9%	18.3%
Publishing	687	760	858	1,039	1,171	10.6%	12.9%	21.0%	12.7%
Music	536	523	539	601	665	-2.4%	3.1%	11.4%	10.8%
Filmed Entertainment	867	1,153	972	1,114	1,225	33.0%	-15.7%	14.6%	9.9%
WB Network	(92)	(91)	(58)	(18)	44	-1.1%	-36.5%	-68.0%	-337.3%
Cable	2,558	4,713	2,837	3,218	3,639	84.2%	-39.8%	13.4%	13.1%
AOL	409	1,241	2,281	3,673	5,128	203.4%	83.8%	61.0%	39.6%
Time Warner Digital Media	0	(16)	(200)	(100)	(25)				
Intersegment Elimination	(94)	(10)	(68)	(105)	(130)	-89.4%	580.0%	54.4%	23.8%
Total EBITDA	**6,147**	**9,802**	**8,942**	**11,592**	**14,285**	**59.5%**	**-8.8%**	**29.6%**	**23.2%**
Total EBITDA (Without Synergies)	**6,147**	**9,802**	**8,942**	**10,657**	**12,965**	**59.5%**	**-8.8%**	**19.2%**	**21.7%**
Depreciation	(1,494)	(1,478)	(1,722)	(1,925)	(2,183)	-1.1%	16.5%	11.8%	13.4%
Amortization	(8,405)	(8,393)	(8,438)	(8,438)	(8,438)	-0.1%	0.5%	0.0%	0.0%
Operating Income	(3,752)	(69)	(1,218)	1,230	3,664	-98.2%	1668.2%	-200.9%	198.0%
Interest & Other, Net	(2,008)	(1,099)	(1,986)	(1,876)	(1,626)	-45.3%	80.7%	-5.5%	-13.3%
Minority Interest	(338)	(475)	(307)	(353)	(406)	40.5%	-35.4%	15.0%	15.0%
Corporate Expenses	(220)	(251)	(284)	(265)	(294)	14.1%	13.1%	-6.5%	10.9%
Pretax Income	(6,318)	(1,894)	(3,795)	(1,265)	1,338	-70.0%	100.4%	-66.7%	-205.7%
Income Tax	1,072	(627)	27	(1,038)	(2,079)	-158.5%	-104.3%	-3929.8%	100.3%
Income Before Extraordinary Items	(5,246)	(2,521)	(3,768)	(2,303)	(741)	-51.9%	49.5%	-38.9%	-67.8%
Extraordinary Loss on Debt Retirement	-	(12)	(425)	-	-				
Net Income	(5,246)	(2,533)	(4,193)	(2,303)	(741)	-51.7%	65.5%	-45.1%	-67.8%
Preferred Dividends	(540)	(52)	(15)	-	-	-90.4%	-71.2%		
Income for Common	($5,786)	($2,585)	($4,208)	($2,303)	($741)	-55.3%	62.8%	-45.3%	-67.8%
Income to Common Before Extra. Items	(5,786)	(2,573)	(3,783)	(2,303)	(741)	-55.5%	47.0%	-39.1%	-67.8%
[redacted]									
Shares Outstanding	4,460	4,790	4,805	4,853	4,902				
Effective Tax Rate	-17%	33%	-1%	82%	-155%				
EBITDA Margins:									
Cable Networks	23.7%	25.0%	25.3%	26.5%	27.1%				
Publishing	15.3%	16.3%	18.6%	20.5%	21.7%				
Music	13.3%	13.6%	13.9%	14.5%	15.0%				
Filmed Entertainment	10.9%	14.3%	11.2%	11.9%	12.3%				
Broadcasting-The WB Network	-35.4%	-23.7%	-12.7%	-3.7%	7.5%				
Cable	47.9%	87.7%	46.9%	46.3%	46.0%				
AOL	10.6%	21.7%	28.4%	33.6%	36.4%				
Total EBITDA	20.4%	29.7%	23.9%	26.5%	28.3%				
[redacted]									

Source: Company reports and First Union Securities, Inc., estimates
Note: AOL has a June fiscal year end. However, to ease comparability, earnings are presented on a calendar year end basis. iThis consistent with the merged company's planned fiscal year.

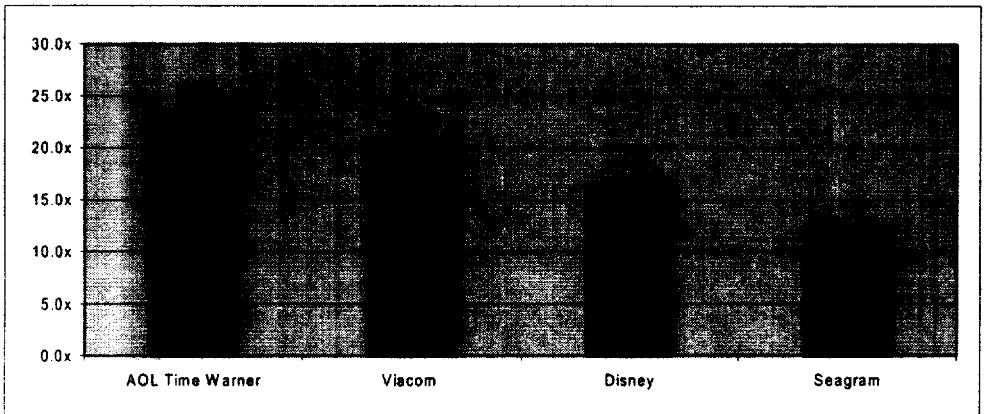
VALUATION AND INVESTMENT CONCLUSION

Comparable Multiples—EV/EBITDA And Cash Earnings

Why the controversy over valuation?... it's cheap!

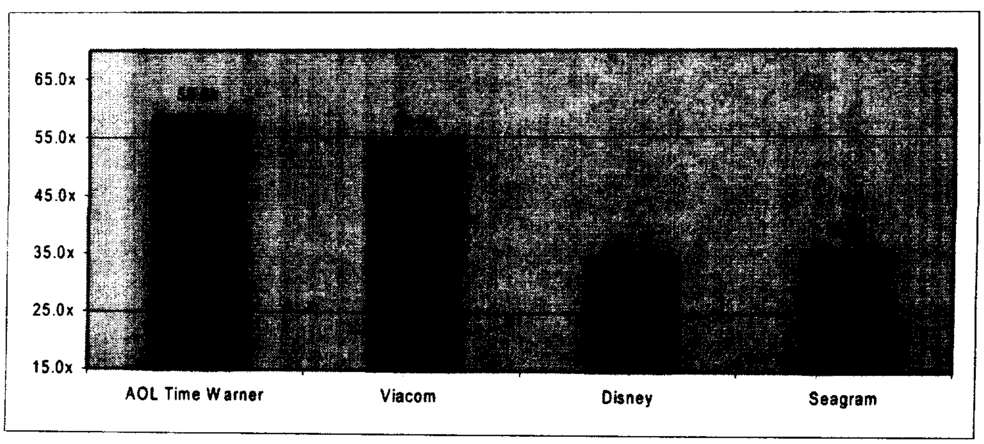
As discussed earlier, it seems that one of the Street's favorite topics is the controversy over how to value AOL Time Warner. At current levels, we are hard pressed to explain the dilemma. We believe it is cheap even from our value-oriented perspective given the economics involved. As shown in Chart 2, AOL Time Warner is currently trading at a 23.6x multiple of enterprise value to our 2001 estimate of EBITDA. While this is clearly at the high end of the comparable range, it is trading on par with its long-term EBITDA growth. In contrast, the other companies in our universe normally trade at a 25% premium to long-term growth. This anomaly is particularly unjustified for AOL Time Warner given that the company converts more of its EBITDA into free cash flow than any other company in the media and entertainment universe—arguing for a higher multiple. On a cash-earnings basis, AOL Time Warner is trading at a 5 8.6x multiple of 2001 cash earnings of $0.93 per share (see Chart 3). Again, at first pass, this multiple may appear to be on the high side, but not after considering that cash earnings should grow close to 50% for the foreseeable future. The multiples are high in absolute terms, but in relation to the underlying economics, we view AOL Time Warner as a growth story trading at a very attractive value.

Chart 2: EV/EBITDA 2001E Multiple Comparison



Source: First Union Securities, Inc., estimates.

Chart 3: Cash Earnings 2001E Multiple Comparison



Source: First Union Securities, Inc., estimates.

Our 12-month target price is $80 per share...47% upside

As detailed in Table 3, we look for impressive 23-25% long-term EBITDA growth with synergies pushing 2001 EBITDA to 30%. Cash earnings should compound closer to 50% in the long term. We estimate free cash flow at more than 50% of EBITDA in 2001, and more than 60% in 2002 (see Table 4). It helps that the company will pay very little in cash taxes (only state and foreign) due the $10 billion in net operating losses (NOLs) at its disposal. NOLs arise from employees exercising stock options, whereby the company is raising capital below market rates, and therefore has to recognize a loss. The ability to generate so much free cash flow creates a desirable problem—one of the biggest challenges for the company is to figure out what to do with all that free cash flow. Buying back stock is an obvious alternative, while further acquisitions (perhaps to further its AOL Anywhere strategy) cannot be ruled out. For modeling purposes we have unimaginatively assumed the repayment of debt.

Nevertheless, the point is that the economics here are very powerful. With strong growth and free cash flow generation, we believe that a 27x multiple of EBITDA is easily sustainable one year from now. This is equivalent to a 58x multiple of cash earnings, which is on par with current levels. As a result, we arrive at a 12-month target price of $80 per share—47% upside from current levels. This valuation is also consistent with our private market value analysis, which suggests that the company is worth about $80 per share (see Table 5).

Table 3: Media & Entertainment Valuation Comparison

	AOL Time Warner	Viacom	Disney	Seagram
Current Stock Price	$55	$67	$42	$64
Rating	1	2	2	3
Projections				
EBITDA - '99	$7,472	$4,181	$4,499	$2,014
EBITDA - '00E	8,914	5,118	5,103	2,579
EBITDA - '01E	11,592	6,125	6,158	2,985
EBITDA - '02E	14,285	7,108	7,202	3,302
F'99-F'02E Growth Rate	24%	19%	17%	16%
LT Growth Rate	23%-25%	15%-16%	10%	10%
Cash Earnings - '99	$0.50	$0.85	$0.82	$1.47
Cash Earnings - '00E	0.65	0.94	0.94	0.96
Cash Earnings - '01E	0.93	1.25	1.21	1.79
Cash Earnings - '02E	1.37	1.70	1.50	2.30
'99-'02E Growth Rate	40%	26%	22%	59%
LT Growth Rate	45%-50%	30%	20%	20%
Free Cash Flow - F'01E	$5,794	$2,650	$1,466	$486
Free Cash Flow - F'02E	8,680	3,404	2,720	655
FCF as % of EBITDA F'01E	51%	45%	24%	24%
FCF as % of EBITDA F'02E	62%	49%	38%	29%
Debt/'01E EBITDA Multiple	1.5x	2.1x	1.7x	2.3x
Current Valuation Statistics				
EV/EBITDA Multiple '00E	30.6x	24.9x	20.2x	14.8x
EV/EBITDA Multiple '01E	23.6x	20.8x	16.8x	12.7x
EV/EBITDA Multiple '02E	19.1x	17.9x	14.3x	11.5x
'01E EBITDA Multiple to LT Growth Rate	98%	134%	168%	127%
Cash Earnings Multiple '00E	83.8x	71.3x	44.6x	66.7x
Cash Earnings Multiple '01E	58.6x	53.6x	34.7x	35.8x
Cash Earnings Multiple '02E	39.8x	39.4x	28.0x	27.8x
'01E Cash Earnings Multiple to LT Growth Rate	123%	179%	173%	179%
12-Month Targets				
Price Target	$80	$80	$48	$75
Appreciation to Price Target	47%	19%	16%	17%
Target EBITDA Multiple - '02	27.3x	20.7x	16.3x	13.1x
Target Cash Earnings Multiple - '02	58.4x	47.1x	32.3x	32.6x
Private Market Value	$80	$77	$48	$75

Source: First Union Securities, Inc., estimates
* EBITDA is presented excluding non-recurring items. Viacom's EBITDA is presented before online start-up losses.
** Cash earnings are defined as net income + amortization of goodwill +/- any purchase accounting adjustments that may distort the underlying cash flow. AOL Time Warner's cash earnings are adjusted for non-cash taxes due to company's NOLs. Disney's cash earnings include 72% of the operating losses from Go.com. Seagram's cash earnings are presented on a calendared basis.